Governmental Employer Manual

A Guide to Social Security/Medicare Coverage and Reporting for Kentucky Governmental Employers

April 13, 2004

Contents

Introduction

This material has been compiled by the Division of Social Security (DOSS), in conjunction with the Kentucky Governmental Employers' Network, in the hope that state and local government employers will find it helpful in preparing and filing accurate and timely wage reports. Our goal is to provide assistance at a level that will be useful for those preparing their first payroll, as well as, at a level that will benefit veteran payroll officials.

This is NOT an official publication of the Internal Revenue Service or the Social Security Administration. Information contained within this manual does not amend or supersede existing laws and regulations. The basic annual wage reporting requirements are set out in the Internal Revenue Code, in Internal Revenue Service regulations and rulings and in IRS and Social Security Administration forms and instructions.

We welcome any comments and suggestions for improvement of the contents, text or topics of this manual. These, plus any questions about Social Security or Medicare coverage or the scope of coverage under a Section 218 Agreement of a Kentucky governmental employer should be addressed to:

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State Controller's Office
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Frankfort, Ky. 40601
Telephone: 502/564-3952
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This manual will be made available in other media upon request to accommodate those individuals with special needs.

The Division of Social Security

After Congress approved legislation allowing certain groups of state and local employees to voluntarily participate in Social Security, the Kentucky General Assembly passed the Kentucky Social Security Enabling Act, during its 1951 Extraordinary Session. Governor Lawrence W. Wetherby, on April 27, 1951, signed the master federal-state agreement permitting Social Security coverage to be extended to the Commonwealth's state and local government employees. The enabling legislation created the Division of Personnel Security which was responsible for administering the Commonwealth's Social Security program.

The division remained a part of the Department of Economic Security until 1974 when it came under the Cabinet for Human Resources. On June 15, 1980, the division was renamed the State Office for Social Security and transferred to the Finance and Administration Cabinet.

The Governor's Commission on Quality and Efficiency recommended in 1993 that a state controller be established to manage the state's finances and, in 1994, the office became the Division of Social Security, attached to the Controller's Office.

The functions of the DOSS during its initial 36 years included collecting and reporting FICA contributions from Kentucky's state and local employers and employees, as well as administering the coverage portion of Social Security. In 1987, the Internal Revenue Service became a participant in the nation's FICA programs and assumed responsibility for collecting FICA contributions. The DOSS, however, continues to be responsible for ensuring that the Social Security obligations of the Commonwealth and its political subdivisions are met.

Because of the IRS's increasing involvement with Social Security and Medicare, the DOSS has been forced to involve itself in the general area of employment tax reporting. The DOSS maintains direct contact with the IRS and serves as a liaison between the Commonwealth's political subdivisions and the IRS.

The DOSS reports and reconciles federal employment wage and tax data for state employees, reconciles wages and contributions paid prior to January 1987 for all government agencies and collects delinquent accounts. The 218 Agreements for Social Security coverage are negotiated by the DOSS which must determine the eligibility of political subdivisions, coverage groups and exclusions. The extent of coverage under 218 Agreements is determined by the DOSS which will assist any political subdivision with the interpretation of coverage contained in a 218 Agreement.

Social Security Coverage

Prior to 1951 Social Security coverage for state and local government employees was not available. On January 1, 1951, federal law allowed voluntary Social Security coverage for the employees of state governments and their political subdivisions through an agreement between the federal government and each state. As the legal provisions for such an agreement is included in Section 218 of the Social Security Act, it is referred to as a **"Section 218 Agreement"**.

In the beginning, Social Security for public employees was limited to those employed in positions not covered by a retirement system. The employer had only to negotiate a Section 218 Agreement with the Commonwealth to provide Social Security coverage. The Social Security Act was amended in 1954 to allow Social Security coverage for public employees in positions covered by a retirement system.

Political subdivisions provide Social Security coverage by entering into a Section 218 Agreement with the Division of Social Security. Once a Section 218 Agreement is signed with the political subdivision, the Commonwealth's master agreement with the federal government is modified to include the new entity and its coverage groups.

Once a Section 218 Agreement is enacted, any services performed by an employee will be covered for Social Security purposes, unless specifically excluded in the agreement. The employee and the employer will begin paying contributions equivalent to the employee/employer share of FICA taxes and the employee will begin accruing Social Security benefits.

The term "political subdivision" includes not only cities, counties and boards of education, but also libraries, housing authorities, water districts, solid waste management districts, airport boards, conservation districts, park boards, etc. Generally, if an entity is created by an act of the legislature, by a vote of the public or by another political entity, it is a political subdivision.

If a political subdivision desires Social Security coverage for the employees who are covered by a qualified retirement system, then the political subdivision has two options and may request a majority vote or divided vote referendum. The first option is a majority vote referenda. Kentucky is authorized under Section 218(d)(3) of the Act to conduct majority vote referenda for coverage. If a majority of the eligible members of the retirement system (not a majority of those voting, unless all those voting are actually all of the eligible members of the retirement system) vote in favor of coverage, Kentucky may then submit a modification to its agreement to extend coverage to that group.

The second option is the divided vote referenda. Section 218(d)(6)(c) of the Act authorizes Kentucky to divide a retirement system based on whether the employees in positions under that system desire Social Security coverage. This allows individuals the personal option to be covered or not covered for Social Security and/or Medicare and does not depend on a majority ballot voting.

Social Security coverage is extended by "coverage groups" and cannot be extended to individual employees. Coverage groups must be distinct and easily defined. Two examples: 1) A city elects to cover all its employees except those in elective positions. 2) The Commonwealth of Kentucky provides coverage to all groups of state employees except those who are members of the Kentucky Teachers Retirement System.

Employers can designate certain groups as optional exclusions to Social Security coverage in their Section 218 Agreement. These exclusions have to be included in the Section 218 Agreement at the time of its ratification. The agreement cannot be modified to add an exclusion at a later date, but an exclusion may be withdrawn and coverage extended to services performed in these positions.

Social Security coverage may not be terminated once coverage is enacted under a Section 218 Agreement. Social Security coverage continues under a Section 218 Agreement even if the services are, at a later date, covered by a retirement system. For example, in 1990, a city with

employees who had no retirement coverage entered into a Section 218 Agreement with the DOSS to provide Social Security coverage to its employees. The Social Security coverage continued after the city provided a retirement system to its employees in 1995.

Optional exclusions are available for:

Elective positions—These individuals may be elected by a legislative body, by a board or committee or by a qualified electorate of the jurisdiction involved. The method of selection must constitute an election as defined in the Kentucky Revised Statutes.
Part-time positions—This is a position which, as established, does not require services in excess of 200 hours per calendar year. It is important to note that the "position" is the controlling factor, not the amount of work performed by the employee. For example, employees in a job normally work only 150 hours a year. One employee, though, must work 350 hours in a particular year. That "position" would still be excluded since the job normally requires under 200 hours per year.
Student Services—These are services performed by a student currently enrolled and attending classes at the school for which the student is working. The key here is "currently enrolled and attending classes." Thus, services performed while school is not in session (summer break) are covered for FICA purposes

There are also universal exclusions applied for:

(1) positions under work relief and other programs designed strictly to relieve unemployment,
(2) payments for services performed by inmates or patients in a hospital, home or institution and
(3) election officials and election workers paid less than a threshold amount (listed in Appendix A) during a calendar year.
(4) Kentucky also has a statewide exclusion for services performed on a temporary, emergency basis, such as flood, fire, earthquake, storm, snow or other similar emergency.

Withholding under the Federal Insurance Contribution Act (FICA) fall into two categories—Social Security and Medicare. Initially, withholding was for Social Security only, then Medicare was added in 1965. In a fundamental policy shift of historic proportion regarding voluntary participation by the states, Medicare was made mandatory for all employees hired after March 31, 1986, who do not have full-FICA coverage (both Social Security and Medicare) under a Section 218 Agreement.

Optional Medicare-only coverage may be provided to certain employees via identical referendum procedures described above for Social Security coverage. This option is available only to employees whose positions are not covered by a Section 218 Agreement, who were hired prior to April 1, 1986 and who are participating members of a qualified retirement system.

In a further erosion of the voluntary coverage concept, the federal government now requires all state and local government employees who are not covered under a Section 218 Agreement and who are not participating members of a qualified retirement system (as defined in Section 3121 of the Internal Revenue Code and its regulations) be provided with Social Security and Medicare coverage for services performed after July 1, 1991. This is referred to as "mandatory FICA."

Mandatory FICA does not supersede a Section 218 Agreement, but it may require services performed in positions excluded by the Section 218 Agreement to be placed under Social Security coverage. For example, a city has a Section 218 Agreement which excluded elected positions, such as the mayor and council members, from Social Security coverage. Under the rules of mandatory FICA, if those individuals holding the elected positions are not participating members of an employer-provided (city-provided) qualified retirement system, employee and employer FICA contributions must be withheld, regardless of any exclusion included in the city's Section 218

Agreement.

Also, under mandatory FICA, substitute and part-time teachers must contribute to Social Security and Medicare if they are not members of a board of education-sponsored, qualified retirement system, even though their full-time counterparts are excluded because of their participation in the Kentucky Teachers Retirement System. Substitute and part-time teachers may be excluded from Social Security if they are receiving KTRS retirement benefits and meet the IRS definition of a "rehired annuitant".

The following checklist can be used to determine most employees' withholding status under FICA:

1. Is the employee's position covered under an employer's Section 218 Agreement?

If the position is not covered by a Section 218 Agreement, proceed to Item 2. If the position is covered by a Section 218 Agreement, both Social Security and Medicare must be withheld, and you can ignore the next two steps as they do not apply to this employee.

2. Is the employee a participating member of a qualified retirement system as defined in IRC Section 3121(b)7 and associated regulations?

If the employee is not a participating member of a qualified retirement system, both Social Security and Medicare must be withheld. If the employee is such a member, the employee is exempt from only the Social Security portion of FICA. Proceed to Item 3 to determine the employee's status for Medicare withholding.

3a. Was the employee:

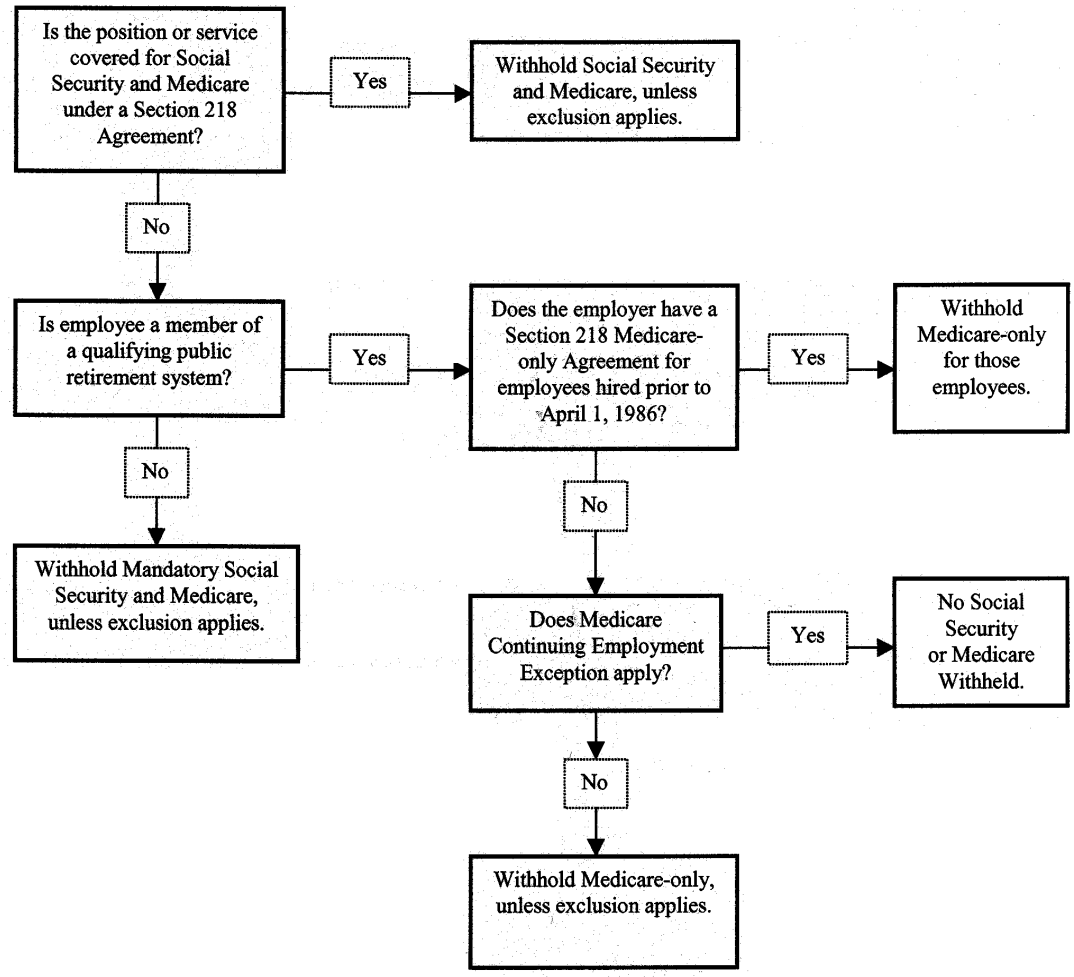
a) hired after April 1, 1986, or
b) not performing regular and substantial service before April 1, 1986, or
c) not a bona fide employee on March 31, 1986, or
d) employment relationship terminated after March 1, 1986?

3b. Has the employer voluntarily elected Medicare-only coverage under the Section 218 Agreement?

If the answer is "yes" to either condition, Medicare must be withheld.

SOCIAL SECURITY AND MEDICARE COVERAGE OF KENTUCKY LOCAL GOVERNMENT EMPLOYEES

(November 2002)



NOTE: This chart is meant as a guide only and is not a substitute for discussing difficult Section 218 coverage situations with the Kentucky Division of Social Security or FICA taxation issues with the IRS FSLG Specialist for Kentucky.

Employees

Government employers in Kentucky must withhold, deposit, report and pay state and federal income taxes, as well as, local taxes in some areas. In addition, government employees may be subject to Social Security and/or Medicare taxes. Wages subject to these taxes include all remuneration given an employee for services performed. The remuneration may include salaries, allowances, bonuses, commissions, per diem payments and certain fringe benefits.

The primary methods for computing the amount of federal income tax to withhold from a Kentucky government employee's wages are the wage-bracket method and the percentage method. Both utilize tables provided in IRS Publication 15. The employer may use either withholding method, but the prime consideration is probably the number of employees and the type of payroll system and payroll equipment used. The employer may change from one method to another at will, and may use one method for a group of employees and a second method for another employee group.

Please note that the wage-bracket tables do not account for quarterly, semiannual or annual payroll periods, which means the percentage tables must be used in these instances. Also, if the employee's wages exceed the amounts given in the wage-bracket tables, then the percentage tables must be used. When using the percentage tables, employers must reduce wages by the amount of total withholding allowances before using these tables.

Each new person hired should be asked to show his or her Social Security card so the employer can accurately transcribe the name and Social Security number to the employer's records. Then, when Form W-2s are prepared for these employees, the employer can be sure their wages will be correctly credited to their Social Security records.

If the employee has not applied for a Social Security card, he or she should be advised to contact any Social Security office. A card is usually available within two weeks. Once received, the employee should show it to the employer so the number can be recorded in the employer's records.

Employers must complete U.S. Immigration and Naturalization Service Form I-9 (Employment Eligibility Verification) and examine evidence of identity and eligibility for work for each new employee.

New employees must complete Form W-4 (Employee's Withholding Allowance Certificate) that shows what income tax amounts should be withheld from their wages. At the end of the calendar year, employers should advise employees to update their Forms W-4, if necessary. Employees who claimed exemption from withholding for the year must file a new Form W-4 by February 15 to continue the exemption into the next year.

The employer must send to the IRS copies of certain Forms W-4 received during the quarter from employees still employed at the end of the quarter. Send copies when the employee claims more than 10 withholding allowances or the employee claims exemption from withholding when the employee's wages would normally exceed $200 per week. No other Forms W-4 are to be sent to the IRS unless specifically requested by the IRS. The Forms W-4 meeting the above criteria should accompany the Form 941 copies sent to the Ogden IRS Service Center at the end of each quarter.

All employees should be reminded to file a new Form W-4 if a change in withholding should be made because of marriage, divorce or other change of circumstances. When completion of these forms shows the employee has had a recent change of name, the employer should advise him or her to report the name change to the SSA and obtain a corrected Social Security card. This is important since the SSA will match the Form W-2 reports filed for employees to the SSA's record of Social Security names and numbers.

To continue receiving advance payments of earned income credits, employees must file a new Form W-5 (Earned Income Credit Advance Payment Certification) with the employer.

WHO IS AN EMPLOYEE?

* Under the Social Security Act, the term “employee” includes:
a) An individual who, under the usual common-law rules applicable in determining an employer-employee relationship, has the status of an employee, and b) An officer of a state or political subdivision.

* Section 3401(c) of the Internal Revenue Code defines “employee” as:
An officer, employee or elected official of the United States, a state or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing.

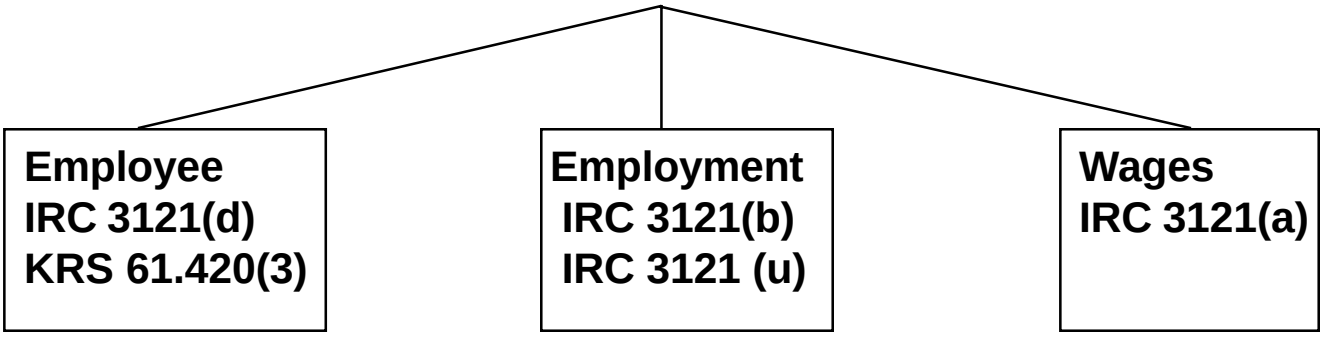
* The Kentucky Revised Statutes—KRS 61.420(3)—says an “employee” is:
Any person in the service of the Commonwealth, a political subdivision or an interstate instrumentality of which the Commonwealth is a principal and shall include all persons designated officers, including those which are elected and those which are appointed.

Elected and appointed officials are considered officers and therefore employees of their political subdivision for federal employment tax purposes. Such Kentucky local officials include, but are not limited to, mayors, city council/commission members, school board members, conservation district supervisors, any board/commission members appointed by the city or county. Wages paid these employees should be report at the end of each calendar year on Form W-2, not Form 1099.

Services performed by elected and appointed officials are, generally, covered for social security and medicare purposes and such taxes should be withheld from any wages paid.

Some officials, however, due to the current or past participation in a public retirement system may be exempt from the social security portion of the FICA tax but may be covered for medicare. Contact the Kentucky Division of Social Security to inquire about the conditions of a Section 218 Agreement and the appropriate social security and medicare coverage for elected and appointed officials.

FICA



Employee:

IRC 3121(d) The term employee means:

(2) any employee who, under common law rules, has the status of an employee, or

(4) any individual who performs services that are included under a Section 218 Agreement.

KRS 61.420 The term employee means:

(3) any person in the service of the Commonwealth, a political subdivision...and shall include all persons designated as officers, including those which are elected and those which are appointed.

Employment:

IRC 3121(b) The term employment means any service, of whatever nature, except...

(7) service in the employ of a state or political subdivision, except...

(E) service included under a Section 218 Agreement, or

(F) service in the employ of a state or political subdivision by an individual who is not a member of a qualified public retirement system.

IRC 3121(u)

(2) Medicare tax shall be imposed on state and local employment, except...

(B) service included under a Section 218 Agreement, or

(C) service performed by an individual who was performing regular and substantial service before April 1, 1986.

Wages:

IRC 3121(a) The term wages means all remuneration for employment except that which is excluded.

INDEPENDENT CONTRACTOR VERSUS EMPLOYEE

The courts have considered many facts in deciding whether a worker is an independent contractor or an employee. These facts fall into three main categories.

- Behavioral Control
- Financial Control
- Relationship of the Parties

Behavioral Control

Included under this category are facts that show whether the government entity has a right to direct and control how the worker performs the specific task for which he or she is engaged. This includes evaluation of the following issues.

Instructions

An employee is generally subject to the government entity's instructions about when, where and how to work. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved.

Virtually ever government entity will impose on workers, whether independent contractors or employees, some form of instruction (for example, requiring that the job be performed within specified time frames). This fact alone is not sufficient evidence to determine the worker's status.

As with every relevant fact, the goal is to determine whether the government entity has retained the right to control the details of a worker's performance or, instead, has given up its right to control these details. Accordingly, the weight of "instructions" in any case depends on the degree to which instructions apply to how the job gets done rather than to the end result.

Instructions about how to do the work may cover a wide range of topics, for example:

- when to do the work
- where to do the work
- what tools or equipment to use
- what workers to hire to assist with the work
- where to purchase supplies or services
- what work must be performed by a specified individual (including ability to hire assistants)
- what routines or patterns must be used
- what order or sequence to follow

The requirement that a worker obtain prior approval before taking certain actions is an example of instructions.

Degree of Instruction

The degree of instruction depends on the scope of instructions, the extent to which the government entity retains the right to control the worker's compliance with the instructions and the effect on the

worker in the event of noncompliance. All these provide useful clues for identifying whether the government entity keeps control over the manner and means of work performance (leaning toward employee status), or only over a particular product or service (leaning toward independent contractor status).

The more detailed the instructions are that the worker is required to follow, the more control the government entity exercises over the worker, and the more likely the government entity retains the right to control the methods by which the worker performs the work. Absence of detail in instructions reflects less control.

Presence of Instructions or Mandated Rules

Although the presence and extent of instructions is important in reaching a conclusion as to whether a government entity retains the right to direct and control the methods by which a worker performs job, it is also important to consider the weight to be given those instructions if they are imposed by the government entity only in compliance with governmental or governing body regulations. If a government entity requires its workers to comply with rules established by a third party (for example, municipal building codes related to construction), the fact that such rules are imposed by the government entity should be given little weight in determining the worker's status. However, if the government entity develops more stringent guidelines for a worker in addition to those imposed by a third party, more weight should be given to these instructions in determining whether the government entity has retained the right to control the worker.

Suggestions v. Instructions

A suggestion does not constitute the right to direct and control. If compliance with the suggestions are mandatory, then the suggestions are, in fact, instructions.

Unique Identification

In the past, a requirement that a worker wear a uniform or put a logo on a vehicle had typically been viewed as consistent with employee status.

If the nature of the worker's occupation is such that the worker must be identified with the government entity for security purposes, wearing a uniform or placing the government entity's name on a vehicle is a neutral fact in analyzing whether an employment relationship exists.

Nature of Occupation

The nature of the worker's occupation also affects the degree of direction and control necessary to determine worker status. Highly trained professionals such as doctors, accountants, lawyers, engineers or computer specialists may require very little, if any, training and/or instruction on how to perform their services. In fact, it may be impossible for the government entity to instruct the worker on how to perform the services because it may lack the essential knowledge and skills to do so.

Generally, such professional workers who are engaged in the pursuit of an independent trade, business or profession in which they offer their services to the public are independent contractors and not employees. Nevertheless, an employer-employee relationship can exist between a government entity and workers in these occupations.

In analyzing the status of professional workers, evidence of control or autonomy with respect to the

financial details of how the task is performed tends to be especially important, as does evidence concerning the relationship of the parties.

Nature of Work For Instructions

The absence of need to control should not be confused with the absence of right to control. The right to control as an incident of employment requires only such supervision as the nature of the work requires. The key fact to consider is whether the government entity retains the right to direct and control the worker, regardless of whether the government entity actually exercises that right.

Evaluation Systems

Like instructions, evaluation systems are used by virtually all government entities to monitor the quality of work performed by workers, whether independent contractors or employees. Thus, in analyzing whether a government entity's evaluation system provides evidence of the right to control work performance or the absence of such a right, you should consider how the evaluation system may influence the worker's behavior in performing the details of the job.

If an evaluation system measures compliance with performance standards concerning the details of how the work is to be performed, the system and its enforcement are evidence of control over the worker's behavior. The lack of a formal evaluation system is, however, a neutral factor.

Training

An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

Detailed Methods and Procedures

Training is a classic means of explaining detailed methods and procedures to be used in performing a task. Periodic or ongoing training provided by a government entity about procedures to be followed and methods to be used indicates that the government entity wants the services performed in a particular manner. This type of training is strong evidence of an employer-employee relationship.

Not all training, however, rises to a level signifying an employer-employee relationship. The following types of training, which might be provided to either independent contractors or employees, should be disregarded:

- orientation or information sessions about a government entity's policies, or applicable statutes or government regulations, and
- programs that are voluntary and are attended by a worker without compensation.

Financial Control

This category includes facts which illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted. It also includes facts pertaining to whether there is a significant investment, unreimbursed expenses, services available to the market, and opportunity for profit/loss. The method of payment must also be considered.

- Independent contractors are more likely to have unreimbursed expenses than employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are

especially important. Employees, however, may also incur unreimbursed expenses in connection with services they perform for the government entity.

- An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. A significant investment is not required for independent contractor status, however.

- An independent contractor is generally free to seek out business opportunities. As a result, independent contractors often advertise, maintain a visible business location and are available to work elsewhere. Of course, these activities are not essential for independent contractor status. An independent contractor with special skills may be contacted by word of mouth without need for advertising.

- An employee is generally paid by the hour, week or month. An independent contractor is usually paid by the job. In some professions, however, such as law, it is not unusual to pay an independent contractor hourly.

- The ability to realize a profit or loss is probably the strongest evidence that a worker controls the aspects of services rendered.

Relationship of the Parties

Courts often look at the intent of the parties. This is most often embodied in a contract. Thus, a written agreement describing the worker as an independent contractor is viewed as evidence of the parties' intent that a worker is an independent contractor.

A contractual designation, in and of itself, is not sufficient evidence for determining worker status. The facts and circumstances under which a worker performs services are determinative of workers' status. The IRC provides that the designation or description of the parties is immaterial. The substance of the relationship, not the label, governs the worker status. The contract may, however, be relevant in ascertaining methods of compensation, expenses that will be incurred, and the rights and obligations of each party with respect to how work is to be performed.

In addition, if it is difficult, if not impossible, to decide whether a worker is an independent contractor or an employee, the intent of the parties, as reflected in the contractual designation, is an effective way to resolve the issue. The contractual designation, is very significant in close cases.

The following items may reflect the intent of the parties:

Forms W-2

Filing a Form W-2 usually indicated the parties' belief that the worker is an employee. Workers have succeeded, however, in obtaining independent contractor status even when Forms W-2 were filed.

Corporation

A worker may provide services to a government entity through his or her own closely held or professional corporation. Provided that corporate formalities are properly followed and at least one non-tax business purpose exists, the corporate form is generally recognized for both state law and federal law, including federal tax purposes. Thus, the worker will usually not be treated as an employee of the government entity but as an employee of the corporation.

Employee Benefits

Providing the worker with employee benefits traditionally associated with employee status has been an important fact in several recent court decisions.

If a worker receives employee benefits, such as paid vacation days, paid sick days, insurance or a pension, this constitutes some evidence of employee status. The evidence is strongest if the worker is provided with employee benefits under a tax-qualified retirement plan, IRC section 403(b) annuity or cafeteria plan, because these employee benefits can only be provided to employees by statute. Some decisions, however, have ascribed less weight to the fact that employee benefits were provided.

Other Governmental Characterizations

State laws, or determinations of state or federal agencies, may characterize a worker as an employee for purposes of various benefits. For the purpose of determining worker classification with respect to federal employment tax liability and withholding requirements, characterizations based on these laws or determinations should be weighed with caution and in some cases disregarded, because the laws or regulations involved may use different definitions of employee or be interpreted to achieve particular policy objectives.

·**Discharge or Termination**

The circumstances under which a government entity or a worker can terminate their relationship have traditionally been considered useful evidence bearing on the status the parties intended the worker to have. Some recent court decisions continue to explore such evidence. In order to determine whether the facts are relevant to the worker's status, however, the impact of modern business practices and legal standards governing worker termination need to be considered.

Under a traditional analysis, a government entity's ability to terminate the work relationship at will, without penalty, provided a highly effective method to control the details of how work was performed and, therefore, tended to indicate employee status. Conversely, in the traditional independent contractor relationship, the government entity could terminate the relationship only if the worker failed to provide the intended product or service, thus indicating the parties' intent that the government entity not have the right to control how the work was performed.

In practice, however, the government entity rarely has complete flexibility in discharging an employee. The reasons for which a government entity can terminate an employee may be limited; by law, by contract, or by its own practices. As a result, inability to freely discharge a worker, by itself, no longer constitutes persuasive evidence that the worker is an independent contractor.

·**Termination of Contracts**

A worker's ability to terminate work at will was traditionally considered to illustrate that the worker merely provided labor and tended to indicate an employer-employee relationship. In contrast, if the worker terminated work and payment could be refused or the worker could be sued for nonperformance, this tended to indicate an independent contractor relationship.

In practice, however, independent contractors may enter into short-term contracts for which nonperformance remedies are inappropriate or may negotiate limits on their liability for

nonperformance. For example, professionals, such as doctors and attorneys, are typically able to terminate their contractual relationship without penalty.

Nonperformance of Employees

Employers may successfully sue employees for substantial damages resulting from their failure to perform the services for which they were engaged. As a result, the presence or absence of limits on a worker's ability to terminate the relationship, by themselves, is no longer useful in determining worker status. On the other hand, a government entity's ability to refuse payment for unsatisfactory work continues to be characteristic of an independent contractor relationship.

Because the significance of facts bearing on the right to discharge/terminate is so often unclear and depends primarily on contract and labor law, these facts should be viewed with great caution.

Permanency

Courts have considered the existence of a permanent relationship between the worker and service recipient as relevant evidence in determining whether there is an employer-employee relationship. If a worker is engaged with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence of their intent to create an employment relationship.

A long-term relationship may exist between a government entity and either an independent contractor or an employee. It may exist because the contract may be a long-term contract or contracts may be renewed regularly due to superior service, competitive costs or lack of alternative service providers.

Weighing the Facts and Determining Worker Status

In exploring the relevant facts, it is probable that some will support independent contractor status and others will support employee status. This is because independent contractors are rarely totally unconstrained in the performance of their contracts. Also, employees almost always have some degree of autonomy. The facts need to be weighed as a whole in order to determine whether control or autonomy predominates.

There will occasionally be a contract that does not obviously place the worker in either the employee or contractor category. Form SS-8 (available from the DOSS web site or the Social Security Administration) should be used to determine the status of such "gray area" contracts.

Local government entities should complete a Form SS-8 and submit it, along with a copy of the contract to the Internal Revenue Service. The IRS will then send a Form SS-8 to the worker to be completed. Upon review of both Forms SS-8, the IRS will reach a determination as to the status of the worker.

State government agencies should complete a Form SS-8 and, also, have the worker complete a Form SS-8. Both completed forms should then be forwarded to the Division of Social Security which will, in turn, work with the IRS in reaching a determination.

Mandatory FICA

On July 1, 1991, mandatory FICA coverage became a reality for state and local employees **in positions not covered by a Section 218 Agreement** and who are not qualified participants in a qualified public retirement system.

Political subdivisions **may voluntarily enter into a Section 218 Agreement** with the State Division of Social Security to provide Social Security coverage for their employees, if the employees are qualified participants (according to Internal Revenue Service regulation) of a qualified retirement system (according to IRS regulation). **This is the only way a political subdivision can provide Social Security coverage for employees who are members of a qualified retirement system.** The subdivisions with a Section 218 Agreement can elect to exclude certain positions from Social Security coverage.

Employees who are not qualified participants in a qualified public retirement system must have FICA taxes withheld and matched by the employer. According to the IRS, elected officials who were excluded in the past, meet the definition of an "employee" and must now contribute to FICA unless they are members of the EMPLOYER'S retirement system.

The following is only a general rendition of the regulation governing mandatory FICA, 26 CFR 31.3121(b)(7)-2, and should NOT be relied upon as an official interpretation. The IRS is the sole source of specific and official explanations of the context and content of the regulation. Copies of the regulation may be obtained from the DOSS or from the IRS.

What is a Qualified Retirement System?

In general, the IRS addresses two concepts of retirement systems—the defined benefit system and the defined contribution system.

A qualified defined benefit retirement system (such as the County Employees Retirement System) is a pension, annuity, retirement or similar fund maintained by the state or political subdivision and provides a retirement benefit to the employee that is comparable to the benefits provided under the Old-Age or Retirement portion of Social Security. This determination can be made by applying the retirement system's benefits to Revenue Procedure 91-40, copies of which are available from the DOSS.

A qualified defined contribution retirement system (Section 401(k), 403(b) or 457 plans, for example) is also a governmental employer-maintained pension, annuity, retirement or similar fund which must receive an allocation to the employee's account of at least 7.5 percent of the employee's compensation for services during the period. Combinations of employer and employee contributions may be used to arrive at the 7.5 percent, however, the 7.5 percent cannot include any earnings on the account. The employee's account must be credited with a reasonable interest rate or it must be held in a separate trust subject to fiduciary standards and credited with actual earnings.

The definition of compensation used in determining the qualification of a defined contribution retirement system must generally be no less inclusive than the definition of the employee's base pay as designated by the employer or retirement system. A defined contribution system will not fail to meet this requirement if it disregards any of the following: overtime pay; bonuses; or lump sum payments received on account of death, or separation from employment under a bona fide vacation, compensatory time or sick pay plan or under severance pay plans. In other words, compensation is the employee's base pay. Any compensation in excess of the Social Security contribution wage base may also be disregarded.

Who is a Qualified Participant?

The IRS considers an employee a qualified participant of a defined benefit retirement system if he/she is or ever has been an actual participant in the retirement system and has accrued benefits equal to the Social Security retirement benefit. A qualified participant of a defined contribution retirement system is a member of the retirement system and is having an amount equal to at least 7.5 percent of the employee's base pay deposited to his/her account which is earning a reasonable interest rate or, the funds are placed in a trust subject to fiduciary standards and are credited with actual earnings.

Whether or not an employee is a qualified participant of a retirement system is generally determined on an individual basis.

What About Part-time, Seasonal and Temporary Employees?

A part-time, seasonal or temporary employee, as defined in the IRS regulation, is generally not a qualified participant of a retirement system unless the following conditions are met:

* Any benefit relied upon to meet the qualification requirements must 100 percent non forfeitable.
* The employee must be unconditionally entitled to a single sum distribution upon death or separation of service.
* The distribution must be equal to at least 7.5 percent of the employee's compensation and a "reasonable" interest rate must be paid with the distribution. (A reasonable interest rate is determined after reducing the rate to adjust for administrative expenses.)

The IRS considers a part-time employee as one who normally works 20 hours or less per week and a seasonal employee as one who works full-time less than five months per year. A person performing services under a contractual agreement of two years or less is considered a temporary employee.

In regard to the classification of temporary employees, contract extensions may be considered in determining the temporary status of an employee. Contract extensions may be considered only if there is a significant likelihood that the employee's contract will be extended. The IRS said there is a "significant likelihood" if, on average, 80 percent of the employees in the same or similar position with expiring contracts were offered renewals within the last two academic or calendar years. Also, contract extensions are considered significantly likely if the employee has a history of extension with respect to his/her current position (teachers, for example.)

What is the "Look-Back" Rule?˜

An employer can avoid the need to determine an employee's qualification on a day-by-day basis by using an alternative lookback rule, copies of which are available form the DOSS. Any employer using the lookback rule must use it consistently from year to year and, if it is used for one employee, it must apply to all applicable employees.

The lookback rule says that an employee may be treated as a qualified participant in a retirement system for an entire calendar year if he/she was a qualified participant in the system at the end of the plan year ending in the previous calendar year. New employees are considered qualified participants if it is reasonable to assume that they will be qualified on the last day of the plan year. Employees leaving the system are treated as qualified participants until their departure if it is reasonable to believe they will be qualified on the last day of employment.

The lookback rule has a special section that applies to defined contribution plans where only a partial year is taken into account and includes the requirement that the employee must receive a monthly allocation and prohibits the back-loading of any allocations.

Who is Excluded from Mandatory FICA Coverage?

There are several exclusions that apply to mandatory FICA coverage for services performed by:

* participating members of a qualified public retirement system who are not covered for Social Security purposes under a Section 218 Agreement;
* individuals employed in programs which are designed to relieve unemployment;
* individuals paid for services performed in a hospital, home or other institution where they are a patient or inmate;
* individuals employed on a temporary basis in case of fire, storm, snow, earthquake, flood or other similar emergency;
* election workers and election officials paid less than a threshold amount (see Appendix A) per calendar year;
* employees compensated solely on a fee basis and who are reporting such fees as self-employment income;
* nonresident aliens who hold F1, J1, M1 or Q1 visas;
* students enrolled and regularly attending classes at the school which is the employer and who were not previously covered under a Section 218 Agreement.

Excluded from mandatory Social Security coverage only (not Medicare coverage) are rehired annuitants. These are employees who are former participants in a retirement system who have retired from service with the state or political subdivision and who are either receiving retirement benefits under the retirement system or have reached the normal retirement age under the retirement system.

For example, if a teacher retires from service, begins to receive KTRS benefits and later becomes a substitute teacher in another school district, the teacher would be considered a rehired annuitant and, therefore, excluded from mandatory Social Security coverage. The substitute teacher, being a rehired annuitant, is NOT excluded from the Medicare portion of FICA.

What About Medicare?

There is no change in the Medicare procedures for employees currently participating in a qualified retirement system and not covered under a Section 218 Agreement. Those who are not participating in a qualified retirement system come under the provisions of mandatory FICA coverage and are required to participate in Medicare. There is no “new-hire/old-hire” Medicare differentiation for those under mandatory FICA coverage.

Using the Lookback Rule for Mandatory FICA

An employer can avoid the need to determine if an employee is a qualified participant of a retirement system (for mandatory FICA purposes) on a day-by-day basis by using the "alternative lookback rule." This rule says that an employee may be treated as a qualified participant in the employer's retirement system for an entire calendar year if the employee was a qualified participant in the system at the end of the plan year ending in the previous calendar year.

The following two scenarios assume that a part-time teacher accrues a 100 percent nonforfeitable benefit, as defined by IRC regulations.

Scenario 1

* If a part-time teacher makes a contribution to the KTRS on 12/1/90 for services performed 7/1/89 to 6/30/90 and the teacher receives a KTRS benefit for that plan year ending 6/30/90, is that teacher excluded from mandatory FICA for the calendar year 1991?

The IRS said, "Yes, providing the employer uses the alternative lookback rule consistently for all employees from year to year. The employee status for mandatory FICA for 1992 must be determined again by determining the employee's status with KTRS for the plan year ending 6/30/91."

* Using the same scenario, but the employer does not use the alternative lookback rule. Could the employer request an IRS refund of previously withheld mandatory FICA taxes when the teacher makes a retroactive contribution to the KTRS?

"No. The IRS intended that under the general rule, the employee would still be covered for mandatory FICA and, therefore, ineligible for a FICA refund, even though a retroactive retirement contribution is made. See Reg. 31.3121(b)(7)-2(d)(1)(i) Example 1."

Scenario 2

This scenario concerns employees who are covered by a retirement system, but who must work for six months before becoming contributing members of the system. The retirement system is a defined benefit system and operates on a plan year that begins July 1 and ends June 30.

* Would an individual hired on October 1 be subject to FICA withholding during the first six-month period?

The IRS said, "In the first year of participation, an employee who participates in the retirement system may be treated as a qualified participant on any given day during the employee's first plan year of participation in a retirement system if, and only if, it is reasonable on such day to believe that the employee will be a qualified participant of such plan year. Therefore, the individual would not be subject to FICA withholding during the first six-month period, if it is reasonable to believe that the individual hired on October 1 will be a participant on the last day of the plan year (June 30)."

* Would an individual hired on March 1 be subject to FICA withholding during the first six-month period?

"The same would hold true for an individual hired on March 1."

* Would the employee be required to make retroactive retirement contributions back to his date of hire for the employer to be eligible to apply the lookback rule?

"It is not necessary for the employee to make such payments in order for the employer to be eligible to use the alternative lookback rule."

* Is the defined contribution system treated any differently than a defined benefit system?

"The determination of whether the employee is actually a qualified participant at the end of the plan year must take into account all compensation since the commencement of participation."

Errata

The following is a simple checklist to determine most employees withholding status under FICA:
1. Is the employee's position covered under the employer's Section 218 Agreement? If so, Social Security and Medicare must be withheld, and go no further in regard to this employee. If the position is not covered by the Section 218 Agreement, go to Item 2.
2. Is the employee a participating member of a qualified [as defined in IRC Section 3121(b)(7)(F)] retirement system? If so, the employee is exempt from Social Security withholding only. Go to Item 3 to determine the employee's Medicare status.
3a. Was the employee hired after April 1, 1986, **or** is the employee NOT performing regular and substantial service, **or** was not a bona fide employee on March 31, 1986, **or** was the employment relationship terminated after March 1, 1986?
3b. Has the employer voluntarily elected Medicare-only coverage under the Section 218 Agreement? If the answer is "yes" to either 3a or 3b, Medicare must be withheld regardless of the employee's Social Security coverage status.

* The County Employees Retirement System, the Kentucky Employees Retirement System and the Kentucky Teachers Retirement System have determined that they meet the conditions to be a "qualified retirement system" for mandatory FICA purposes under Section 3121(b)(7)F of the Internal Revenue Code.

* Agencies utilizing retirement programs other than those offered by the CERS, KERS and KTRS must use IRC Section 3121(b)(7)F--and its related regulations--and IRS Revenue Procedure 91-40 to determine if their respective retirement plans meet the IRS guidelines to be a "qualified retirement system" for mandatory FICA purposes. Copies of Revenue Procedure 91-40 are available from the Division of Social Security. NO OTHER DEFINITIONS, QUALIFICATIONS, REGULATIONS OR STATUTES APPLY TO THE REQUIREMENTS OF IRC Section 3121 IN DETERMINING WHAT IS A "QUALIFIED RETIREMENT SYSTEM" FOR MANDATORY FICA PURPOSES.

* According to IRC Section 3401(c), "the term employee includes an officer, employee or ELECTED OFFICIAL of a state or any political subdivision thereof, or any agency or instrumentality of any of the foregoing." Wages for elected officials must be reported on Form W-2.

* A teacher who has retired and is currently receiving retirement benefits from the KTRS but, who has returned to work as a substitute teacher (known to the IRS as a "rehired annuitant") in a KTRS position is excluded from mandatory Social Security. **PLEASE NOTE: Rehired annuitants who are substitute teachers must still contribute to Medicare.** "Even though the services performed may be substantial, the services are not regular because they are performed on an as needed basis," the IRS said. A KTRS retiree who returns to work as a bus driver is covered for full Social Security under Section 218 Agreement.

* The Circular E attempts to clarify student exclusions by stating student services are “taxable only if covered by a Section 218 Agreement. Otherwise, the wages are not subject to Social Security and Medicare.” In other words, all students employed by a board of education are exempt from Social Security and Medicare contributions IF the board of education has a student exclusion and the student is enrolled and regularly attending classes.

If the board does NOT have a student exclusion, or if the student is not enrolled and regularly attending classes, Social Security and Medicare contributions must be withheld because these student services are covered under a Section 218 Agreement.

Student services performed at Kentucky’s state universities are exempt from Social Security and Medicare if the student is enrolled and regularly attending classes, as defined by the IRS and SSA.

Deposit Procedures

The basic rules governing the deposit of withheld federal income tax and both the employer's and employee's FICA taxes depend upon the amount of the employer's total federal tax liability (the combined income and FICA tax amounts). Employers are either a **monthly** or **semiweekly** depositor, based on the total taxes reported on Form 941 in a four quarter lookback period—July 1 through June 30.

Monthly Depositors

If an employer reported total taxes of $50,000 or less during the last two quarters of 1999 and the first two quarters of 2000, the employer would be a monthly depositor during the full calendar year of 2000. Monthly depositors must deposit accumulated employment taxes for the month by the 15th day of the following month.

Semiweekly Depositors

If more than $50,000 was reported during the four quarter lookback period, the employer would be a semiweekly depositor for the full calendar year. Under the semiweekly rule, amounts accumulated from payments made on Wednesday, Thursday and/or Friday must be deposited by the following Wednesday. Amounts accumulated from payments made on Saturday, Sunday, Monday and/or Tuesday must be deposited by the following Friday.

Semiweekly depositors are allowed three banking days to make a deposit. For example, if taxes are accumulated for payment made on a Friday, and the following Monday is not a banking day, deposits made by the following Thursday would be considered timely.

Special Rules

The $2,500 Quarterly Rule--If the amount of tax due is less than $2,500 at the end of a calendar quarter, no deposits are required and this liability may be paid with the quarterly return (Form 941).

The $100,000 One Day Rule--If the total accumulated tax reaches $100,000 or more on any day during a deposit period, it must be deposited by the next banking day. The depositor of $100,000 automatically becomes a semiweekly depositor on the next day and remains so for the remainder of the current year and for the following year.

Safe Harbor Rule--A safe harbor rule provides that penalties will not be assessed if employers deposit in a timely fashion at least 98 percent of the actual tax liabilities (or within $100 of the actual tax liabilities) by the shortfall makeup date.

Shortfall Makeup Date--Monthly depositors meet the shortfall makeup date if the shortfall is deposited by the due date of the Form 941 for the period in which the shortfall occurred. The shortfall may be paid with Form 941 even if the amount exceeds $500. Semiweekly depositors must deposit the shortfall by the first Wednesday or Friday, whichever is earlier, falling on or after the 15th day of the month following the month in which the deposit was required to be made.

If a quarterly return period ends on a day other than Tuesday or Friday, the employment taxes accumulated on the days covered by the return period just ending are subject to one deposit obligation. Employment taxes accumulated on the days covered by the new return period are

subject to a separate deposit obligation. For example, if one quarter return period ends on Thursday and a new quarter begins on Friday, employment taxes accumulated on Wednesday and Thursday must be accounted for the quarter just ending and the taxes accumulated on Friday must be included in the new quarter. Separate federal tax deposits are required for each deposit obligation. If a deposit is required to be made on a day that is not a banking day, it will be a timely deposit if it is made by the close of the next banking day.

Quarterly Reporting

Form 941 (Employer's Quarterly Federal Tax Return) is used by all employers who withhold federal income, Social Security and/or Medicare taxes to file quarterly tax returns. The quarterly return must be filed no later than the last day of the month following the close of the calendar quarter to which it relates.

Quarter	Ending Date	Form 941 Due Date
Jan-Feb-Mar	Mar 31	April 30
Apr-May-June	June 30	July 31
July-Aug-Sept	Sept 30	Oct 31
Oct-Nov-Dec	Dec 31	Jan 31

If the employer deposits all taxes when due for the quarter, the Form 941 is not due until the 10th day of the second month of the following quarter. If the due date for filing a Form 941 falls on a Saturday, Sunday or legal holiday, it may be filed on the next business day.

Form 941 must be filed with Internal Revenue Service. Returns that do not include a payment are mailed to the Internal Revenue Service Center at Cincinnati, OH 45999-0005. Returns with a payment are mailed to the IRS at P.O. Box 7329, Chicago, IL 60680-7329.

Complete one Form 941 per quarter. Do not report more than one calendar quarter on one return.

Form 941 instructions are found on the back of the form. Employers should note, however, that line 8 of the form must be checked if none of the wages are subject to Social Security and/or Medicare taxes.

Completing Schedule B (Employer's Record of Federal Tax Liability) of Form 941

Schedule B of Form 941 is a record of the employer's quarterly tax liability, NOT a summary of deposits made.

Less than $500

If line 13 of Form 941 totals less than $500, line 17 of Form 941 and Schedule B do not have to be completed.

Monthly Depositors

An employer is a monthly depositor if the amount of employment and withholding tax liability is not more than $50,000 during the lookback period which is defined as the four consecutive quarters ending on June 30 of the prior year. For 2001, the lookback period begins July 1, 1999, and ends June 30, 2000.

Monthly depositors do not have to complete Schedule B, however, line 17 of the Form 941 must completed.

Semiweekly and Next Day Depositors

Employers that accumulated an employment and withholding tax liability in excess of $50,000 during the lookback period and employers that accumulate $100,000 or more on any day do not complete columns (a) through (d) of line 17 on the Form 941. Instead, they must complete and attach Schedule B of the Form 941.

Annual Reporting

Form W-2

Employers must file Copy A of the Form W-2 with the Social Security Administration, Data Operations Center, Wilkes-Barre, PA, 18769, no later than February 28 of the following year. All entries on Form W-2 must be based on the calendar year.

The employees' Social Security numbers and employers' employer identification numbers (EIN) are used to check payments reported against the amounts shown on employees' tax returns. It is very important that the correct Social Security and EIN numbers are used.

Forms W-2 are to given to employees by January 31 of the following year. In cases where employment ends prior to December 31, copies may be given any time after employment ends. If the employee asks for a Form W-2, it must be provided with 30 days of the request of the final payment, whichever is later.

Employee copies of Forms W-2 that could not be delivered must be retained for four years.

If a Form W-2 is lost by an employee, the employer may issue a new Form W-2 with the words "Reissued Statement" printed at the top of the new Form W-2. **DO NOT SEND ANY COPIES OF THE REISSUED STATEMENT TO THE SSA.**

The Form W-2 is a six-part form and the information entered on all parts must be legible. It is printed with two forms to an unperforated page. The employer must send the whole Copy A page to the Social Security Administration, even if one of the forms is blank or void.

If possible, all entries should be typed using black ink. Do not make any erasures, whiteouts or strikeovers and do not use script type. All dollar entries must be made without the dollar sign ($) and comma, but with the decimal point (000000.00).

Forms W-2 should be filed either alphabetically by employees' last names or numerically by employees' Social Security Numbers.

NOTE: Special Instructions for "Medicare-Only" Form W-2

Employers must separate Forms W-2 for Medicare-only withholding from full-FICA Forms W-2 and file them separately. If paper forms are used, a separate Form W-3 must accompany the Medicare-only Forms W-2. If magnetic media is used to report Forms W-2, Medicare-only withholding must be submitted under a separate "RE" record with a "Q" in the type of employment field.

For tax years 1991 and later, federal, state or local agencies have two options for reporting their employees' wages that are subject to Medicare-only taxes for part of the year and full Social Security taxes for the remainder of the year.

The first option is to file two Forms W-2, filing one—and checking the Medicare Government Employee box on Form W-3—with wages subject only to Medicare tax. File the second Form W-2 for wages subject to both Social Security and Medicare taxes with the 941 box checked in item b of the Form W-3.

The other option is to file a single Form W-2 with the Medicare-only wages combined with the full Social Security and Medicare wages. The Form W-3 should have the 941 box marked or, if filing on magnetic media, code the type of employment field with an "R".

Magnetic Media

Employers who file 250 of more Forms W-2 must report on magnetic media unless granted a waiver by the IRS.

A waiver, because of a reporting hardship, can be requested on Form 8508 (Request for Waiver From Filing Information Returns on Magnetic Media). Form 8508 must be submitted to the

IRS 45 days prior to the due date of the Form W-2.

An extension of filing time can be requested by filing Form 8809 (Request for Extension of Time to File Information Returns) with the IRS no later than the due date of the Forms W-2.

SSA prefers electronic filing or acceptable magnetic media on 1/2 inch tape, 3480 cartridges, or 3 1/2 inch diskettes. **[Tax year 2004 is the last year SSA wil accept tape or cartridge submissions. Tax year 2005 is the last year for diskette submissions.]** For more information log on to http://www.ssa.gov/employer/.

Form W-3

Form W-3 is a transmittal form that must be filed with Copy A of paper Forms W-2 by employers. The whole first page of the Form W-3 must be filed with COPY A of Forms W-2 no later than the Form W-2 due date. Employers may be penalized if incorrect information is on the return or if the return is filed late.

An extension of the filing deadline may be requested by sending Form 8809 (Request for Extension of Time to File Information Returns) to the address shown on that form. The extension must be requested before the Form W-2 due date.

Do not staple Form W-3 to any Form W-2 and type entries to Form W-3 if possible. Make all dollar entries without the dollar sign ($) and comma, but with the decimal point (000000.00).

Reconciliation

Prior to filing Form 941 for the fourth quarter of a year, the employer's copies of the Form 941s for the first three calendar quarters of the year should be reviewed along with payroll records for the year. Any over or under reporting of wages can then be identified and any over or under payment of taxes for the year can be adjusted on the fourth quarter Form 941.

As the Social Security Administration processes employer wage reports, it maintains a record of total wages and tips processed for each employer. These totals are then compared at the end of the process year with the Internal Revenue Service employment tax records. Employers whose reports to the IRS (Forms 941) and the SSA (Forms W-2) do balance are contacted for an explanation. Failure by employers to resolve these discrepancies may result in penalties for filing incorrect reports.

Once the employee's name and Social Security number on wage reports has been verified, the SSA posts the reported wages to the employee's Social Security record. These wage amounts are then used in calculating the employee's retirement, disability, survivorship and Medicare benefits. Errors in wage amounts to an employee's record are often detected later on, requiring, in most cases, contact with employers for evidence from their files of the correct earnings amounts.

Ways to minimize the number of discrepancies between reports filed with the SSA and the IRS include:

* Reconcile the Social Security wages, Social Security tips, Medicare wages and tips, total wages, tips and other compensation, advance earned income credit and income tax withheld on the four quarterly Forms 941 to Form W-3. The amounts may not match for various reasons. If they do not match, the reason must be valid and reconciliations should be saved to answer any future inquiries by the IRS.

* Use the Form W-2 for the current year.

* File Copy A of all Forms W-2 with the SSA.

* Report bonuses as wages (Form W-2 Box 1) and as Social Security and Medicare wages.

* Enter Social Security taxes in the proper box—not in the box for Social Security wages.

* Make sure Social Security wage amounts do not exceed the current wage base.

* Do not include noncash wages not subject to Social Security or Medicare taxes as Social Security or Medicare wages.

* If filing paper “Medicare-only” Forms W-2, check “Medicare, govt. emp.” in Box b of the Form W-3.

* If filing “Medicare-only” Forms W-2 on magnetic media, place the letter “Q” in the type of employment field of the “RE” record.

Making Corrections

Form W-2c

Once Form W-2 information has been filed with the Social Security Administration, any corrections must be made on Form W-2c (Statement of Corrected Income and Tax Amounts) and Form W-3c (Transmittal of Corrected Income and Tax Statements).

If the only correction is to the employee's name or Social Security number, file only a Form W-2c. If the employee has a name change, the employee must notify the SSA and request a new Social Security card. If any other corrections are made, both Form W-2c and Form W-3c must be filed.

Occasionally, a correction to Form W-2 information is needed before filing such information with the SSA, but after providing the employee with a copy of the Form W-2. Employers may void the erroneous Form W-2 by marking the "void" box at the top of Copy A. Prepare a new Form W-2 with the correct information and send that Copy A to the SSA. Write "Corrected" at the top of the Form W-2 and give the employee their corrected copies.

Form W-3c

Form W-3c is used to accompany Copy A of Form W-2c sent to the Social Security Administration. A separate Form W-3c must be used for each type of Form W-2 being corrected (for example, Medicare-only Form W-2 or full FICA Form W-2) and must accompany a single Form W-2c, as well as with multiple Forms W-2c.

Form 941c

For every Form 941 on which an adjustment is reported a Form 941c (Statement to Correct Information) must be attached explaining why the adjustment is being made, the period covered and any other information required by the instructions of the Form 941.

Income tax cannot be adjusted after the end of the calendar year. If less than the correct amount of Social Security and Medicare is withheld, corrections may be made from future wages. The employer is the party that owes the amount of underpayment.

If more than the correct amount of Social Security and Medicare is withheld, the excess must be returned to the employee. A receipt from the employee with the date and amount of repayment is required. If the overcollection of Social Security and Medicare is for a prior calendar year, the employer must obtain a written statement from the employee stating that the employee has not and will not claim a refund or credit of the overcollection. A Form W-2c must be filed to ensure an adjustment is made to the employee's Social Security and/or Medicare wages.

Form 941 contains instructions on correcting mistakes in reporting withheld income, Social Security and Medicare taxes, including the use of Form 941c. Social Security and Medicare taxes can, generally, be adjusted on a later Form 941. If the Form 941c issued to correct either of these taxes due to a change in wage totals for a previous year, it may be necessary to also file a Form W-2c and a Form W-3c to ensure proper reconciliation.

Generally, adjustments may be made only within three years of the return due date or the date the return is filed, whichever is later. For example, Form 941c could be filed from 1998 wage or tax adjustments until April 15, 2002.

To access forms, go to http://sssa.ky.gov/doss-rpt.htm.

Sources of Assistance

Most questions posed by state and local government employers on annual wage reporting to the federal government can be answered by consulting one of the following Internal Revenue Service or Social Security Administration publications.

Available from the IRS :

* Federal-State Reference Guide (Publication 963)--The Fed-State Reference Guide examines Social Security and Medicare coverage of governmental employees and FICA reporting by governmental employers.
* Employers Tax Guide (Publication 15/15A)—This publication explains employer requirements for withholding, depositing, reporting and paying federal employment taxes.
* Federal Employment Tax Forms (Publication 393)—This provides instructions for preparing annual wage reporting Form W-2 and Form W-3.

Also, information may be obtained from the IRS via two toll-free telephone numbers, (800) 829-1040 for general assistance and (800) 829-3676 for information on forms and publications. Questions related to withholding, reporting and paying federal employment taxes can be directed to the IRS website at www.irs.gov or FSLG website http://www.irs.gov/govt/fslg/index.html. TE/GE Customer Account Services can be reached toll free at (877) 829-5500.

Available from the SSA:

*Magnetic media reporting and electronic filing can be found at http://www.ssa.gov/employer/.
*Additional publications may be obtained by going to www.ssa.gov.
*Access to an SSA regional wage reporting specialist may be gained by contacting the Social Security Administration at 101 Marietta Tower, Suite 1902, Atlanta, GA. 30323 or by telephone at (404) 331-2587.

Available from the Division of Social Security:

* Governmental Employer Manual--The manual is an unofficial guide to Social Security and Medicare coverage and reporting specifically for Kentucky's governmental employers.
* Who Is a Governmental Employee?--This is information on how to determine if an individual is an employee or an independent contractor for a governmental employer.
* Employer Provided Vehicles--These rules can be used to ascertain the taxable value of a vehicle provided to an employee.

DOSS employees will also answer questions from governmental employers regarding Social Security coverage and reporting requirements. The division can be contacted via:

Postal Mail:	403 Wapping St STE 340 Frankfort KY 40601
Telephone:	(502) 564-3952
FAX:	(502) 564-2124
Internet:	http://sssa.ky.gov
E-mail:	finance.socsecurity@ky.gov

Social Security Benefits

The following is a summary of the structure of social security benefits. If more detailed information is required, please contact the nearest federal social security office.

Earning Credit

A person needs credit for a certain amount of work covered by social security to qualify for social security benefits and medicare. Earnings from work or self-employment must be covered under social security to earn social security credits. The amount of money a person needs to earn to receive credits changes each year. For example, in 2004 one social security credit was earned for each $900 of covered wages. Up to four social security credits may be earned each year.

If a person stops working under social security coverage before enough credits have been earned, the credits already earned will remain on the person's social security record. Then, should the person return to work under social security coverage, the previously earned credits are used in any benefit calculation.

The number of credits needed to qualify for social security benefits depends upon the person's date of birth (or age when disabled), or, for survivor benefits, age at the time of death. The number of credits needed will vary with the type of benefit.

The amount of benefits is determined by the amount of the average of social security covered earnings during a working career. The number of social security credits do not determine the amount of benefits, nor does the amount of social security withheld from a person's covered wages.

Retirement

If a person qualifies, reduced retirement benefits may be received as early as age 62. Under current law for most workers, 40 credits are needed to qualify for full retirement benefits or for Medicare at full retirement age.

Social security retirement benefits will replace part of a person's covered preretirement earnings. The replacement rate ranges from about 60 percent of preretirement earnings for a worker who always earned the minimum wage to about 26 percent for a worker who has always earned the maximum covered by social security.

There is a limit on how much most people receiving social security benefits can earn without losing some, or all, of their benefits. If a person works, the earnings may affect the personal benefits and those of the family. If members of the family work, their earnings affect only their benefits. Earning limits change each year and apply to each person between ages 62 and full retirement age receiving social security benefits, except people receiving disability benefits, which operate under different rules.

Survivors

If there is a family, a person must have earned one Social Security credit for each year since 1950 (or since age 21, which ever is later) and a maximum of six credits for certain family members to receive benefits upon the provider's death. Family members may also qualify for benefits if the provider earned six credits in the three years prior to death. The number of credits a person needs to qualify for survivors benefits increases each year until age 62, up to a maximum of 40 credits.

Children and the surviving spouse may qualify for monthly benefits up to a maximum level and may also qualify for a onetime death benefit.

A spouse or former spouse may qualify for benefits upon a person's retirement or disability. Benefits are paid as early as age 62, or at any age if the spouse is caring for the person's child. The child must be under 16 or disabled and receive benefits on the person's record. Spouse's benefits will be one-half or less of "full retirement age" monthly benefit.

Benefits are paid to widows and widowers at age 60, at age 50 if disabled, or at any age if the widow or widower is caring for the deceased's child. The child must be under age 16 or disabled and receive benefits on the deceased's record.

A spouse's, or surviving spouse's, benefit can be affected by the spouse's age, the spouse's work history and the number of other family members who receive benefits on a person's earnings record. This benefit is permanently reduced if the spouse retires before full retirement age and is not caring for a child who receives benefits on a person's record.

Unmarried children under the age of 18 (under 19 if in high school) or any age if disabled before age 22 also may qualify for social security benefits.

Disability

Currently, a person must have earned at least one social security credit for every year from age 22 to the date of disability to qualify for disability benefits. And, 20 of these credits had to be earned in the 10-year period immediately prior to becoming disabled. Fewer credits may be required if a person is blind, if disability benefits have been received in the past, or if a person becomes disabled prior to age 31. The number of credits a person needs to qualify for disability benefits increases each year until age 62, up to a maximum of 40 credits. Benefits may be reduced if workers' compensation or public disability benefits are also received.

Social Security Statement

The Social Security Administration provides a social security statement to workers each year. This statement is a personal record of earnings on which social security tax has been paid and also a summary of estimated disability, retirement and survivors benefits.

The statement can also be requested at anytime by visiting the SSA web page at http://www.ssa.gov or by calling the SSA toll free number 1-800/772-1213.

Pensions from Work not Covered by Social Security

If a person receives a pension from a job that was not covered by Social Security, such as a Kentucky Teachers' Retirement System pension, but the person has enough Social Security credits to be eligible for retirement or disability benefits, a special formula is used to determine a reduced benefit amount.

The special formula affects workers who reach age 62 or become disabled after 1985 and became eligible after 1985 for a monthly pension based in whole or in part on work not covered by Social Security. A person is considered eligible to receive a pension if the requirements of the pension are met, even if the person continues to work.

The Windfall Elimination Provision (WEP)

The WEP primarily affects workers who spent most of the careers working for a government agency, but who also worked at other jobs where they paid Social Security taxes long enough to qualify for retirement or disability benefits. In these cases, Social Security benefits will be figured using a formula different from the one used for those who spent most or all of their working years paying Social Security taxes. The windfall elimination formula results in a reduced Social Security benefit.

Before this provision was enacted in 1983, government employees had their benefits computed as if they were long-term, low-wage workers. Thus, they received the advantage of the higher percentage Social Security benefits in addition to their government pension.

The Government Pension Offset (GPO)

The GPO applies only to workers who get a government pension and are eligible for Social Security as a spouse or widow(er). Two-thirds of the government pension is used to offset any spouse's or widow(er)'s Social Security benefit.

Before the offset provisions were enacted, many government employees qualified for a pension from their agency and for a spouse's benefit from Social Security, even though they were not dependent on their husband or wife.

Alternative Retirement Plans May Reduce SS Benefits

WEP and GPO may reduce benefits for certain government retirees who are eligible for Social Security and a federal, state or local government pension or alternative retirement plans (such as deferred compensation plans) from a job where they did not pay Social Security taxes.

The SSA has outlined five characteristics used to determine if an alternative retirement plan will be considered a pension plan and subject to the WEP and GPO.

An alternative plan is NOT a pension plan when:

* The plan is separate from and in addition to the primary retirement plan, and
* employees voluntarily contribute to the plan, and
* the employer makes no contribution to the plan, and
* withdrawals from the plan do not exceed the employee's contributions plus interest, and
* withdrawals are not based upon age, length of service or earning.

If the alternative plan does not meet the above criteria it will be subject to the WEP and GPO.

The WEP was enacted by the federal government in 1983 and primarily affects people who spend much of their lives in a government job but who also have other jobs where they pay Social

Security taxes long enough to qualify for retirement or disability benefits. In these situations, Social Security benefits will be based on a different formula than the one used to compute benefits for people who paid Social Security taxes for most or all of their working years. The modified formula results in a reduced level of Social Security benefits.

GPO affects only government retirees who are eligible for Social Security benefits as a spouse or widow(er). Two-thirds of the government pension is counted to offset the Social Security benefit.

Social Security benefits for spouses and widow(er)s are intended to provide income to people who are financially dependent on their spouses. Before the offset provisions were enacted in 1977, many government employees qualified for a pension from their agency and for a spouse's benefit from Social Security.

This was considered unfair because those who receive a spouse's or widow(er)'s benefit and are not government employees already were subject to a similar offset that affects their benefits. For example, a woman eligible for $400 in Social Security retirement benefits on her own work record, and also eligible for a wife's benefits of $300 receives only the higher of the two benefits—$400 in this case.

SSA Publication 05-10045, covering the windfall elimination provision, and SSA Publication 05-10007, discussing government pension offset, are available from the Social Security Administration. Employers assisting in retirement planning are urged to provide copies of these publications to their employees.

Defining a Pension for WEP/GPO Purposes

The Omnibus Budget Reconciliation Act 1990 contained a provision which extended Social Security coverage to those governmental employees who are not members of a retirement system—commonly referred to as mandatory Social Security. The provision does not apply if the employee is already covered under Section 218 of the Social Security Act or is a member of a qualified retirement system as defined by IRS regulations. Mandatory Social Security coverage ceases when the governmental employee becomes a member of an employer provided retirement system that conforms to IRS regulations.

Some employers have opted for other than the standard notion of a retirement system such as a deferred compensation plan—a defined contribution plan that allows participation by governmental employees in lieu of mandatory Social Security coverage. This and other plans raise several questions about the applicability of WEP and GPO.

The first step in determining if GPO and/or WEP will apply is to determine if the periodic or lump sum payment is a pension for GPO/WEP purposes. SSA applies the following general rule to each case when determining if a periodic payment or lump sum benefit from a defined contribution plan (or any other plan) is a pension:

If an employee voluntarily contributes to a plan <u>which is separate from and in addition to</u> a primary retirement plan; the employer makes no contributions to the plan; the withdrawals from the plan do not exceed the employee's contributions (plus interest); and withdrawals are not based upon age, length of service or earnings, then the plan is considered a savings plan and is <u>not</u> a pension plan for GPO/WEP purposes.

Examples:

1) A part-time employee for a city is not covered by a 218 agreement. In July 1991, the employee elected to participate in the state's public employees deferred compensation plan in lieu of mandatory Social Security coverage. The employee, upon retirement, will receive a payment from the deferred compensation plan based on employee and employer contributions to the plan, as this

is the only plan to which the employee contributes. This plan is not considered a savings plan for GPO/WEP purposes and the payment will be consider a pension and subject to GPO/WEP provisions.

2) A state employee is not covered by a 218 agreement, but is covered by a state employee retirement system and has also elected to make contributions to a deferred compensation plan. The payment from this deferred compensation plan is separate from and in addition to the primary retirement plan, the employer make no contributions to the plan and the payment from the plan is not based on age, length of service or earnings. While the payment from the retirement system is subject to GPO/WEP provisions, the payment from the deferred compensation plan is not.

FICA Tax Rates and Wage Bases

The Social Security tax rate is 6.2 percent on the employee's taxable wages up to a maximum that is established by the Social Security Administration each year. The Medicare tax rate is 1.45 percent on the employee's taxable wages. Medicare wages paid prior to January 1, 1994 were subject to a maximum wage base established by the Social Security Administration. The total taxable wages paid on and after January 1, 1994, are subject to the 1.45 percent Medicare withholding.

For up-to-date tax rates and wage bases, go to: http://sssa.ky.gov/dosstabl.htm.